

## German market growth benefits from Master KAG structure

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Christian Benigni expects to see strong growth in the German hedge funds business this year and next, and he is well placed to know. Benigni is a principal in the asset allocation group at the UK fund management group, GLG, which launched its first German-domiciled hedge fund in November last year. As one of Europe's top three hedge fund managers with assets under management of approximately USD14 billion, GLG's every move is closely watched. Its decision to set up a German hedge fund was widely seen as a vote of confidence in the marketplace. The growth potential is obvious to all. The German funds market tops the EUR1.2 trillion mark - with around 63 per cent of that in Spezialfonds (corporate pension funds) and the rest in mutual funds. The 2004 Investment Act made it practical to launch German-registered hedge funds for the first time. It also allowed insurance companies and pension funds to invest an additional five per cent of their assets in hedge funds, creating a new EUR60bn market. Managers with proven track records and a good solution in the German market will be best placed to take a large share of this new business.

'Last year, a lot of potential investors were interested, but didn't want to be the ones that made the first move,' Benigni says. 'A lot of mandates were given out for tax-transparent, offshore funds of funds. Now we believe the marketplace is becoming more receptive to domestic single-strategy funds.' His view is supported by Jörg Sittman, general manager and chief operating officer in Citigroup's German KAG (Kapitalanlagegesellschaft) team. In 2004, Citigroup became the first bank in Germany to be licensed to set up a KAG with the focus on servicing hedge funds. The Citigroup entity is designed as a Master KAG to service and administer both long-only and hedge funds. Citigroup Investment Deutschland has successfully launched several single-strategy hedge funds on behalf of third-party clients, GLG among them. Two other asset management firms, arsago and the Munich bank, Baader Wertpapierhandelsbank, have also used Citigroup's Master KAG to launch single-strategy hedge funds in the German market. The arsago fund is a global macro fund, while the Baader fund, Herald Europe-CI, is a long/short fund, like the GLG fund. While the latter is a Europe-wide fund, Herald Europe-CI invests only in the eurozone with a heavy emphasis on DAX and M-DAX stocks.

According to Baader chief executive Uto Baader, one of the reasons for the slow uptake of German hedge funds to date is that international investors do not fully understand the tax implications of the 2004 Act. 'They think that if they want to invest tax-free, they can only invest in offshore funds,' he says. 'But under the investment law, German-registered hedge funds are also now tax-free investments. They have a European passport. International investors can buy them on the same terms as German investors, with no tax deduction at all.' Says Sittmann: 'Last year there was a lot of noise surrounding hedge funds, but not a lot of action. One reason was that insurance companies needed time to build the riskcontrol systems they must have in place under the regulations before they can invest in hedge funds. They also needed to gain an understanding of the different strategies. Now many are ready to make a move.'

While Herald Europe-CI is Baader's first hedge fund, GLG manages 17 different hedge funds. It has been active in Germany since 1997 when it first started selling long-only funds, and for the past five or six years, the firm has also sold index certificates on a bespoke basis to a limited number of investors.

Index certificates are a fund of funds product structured as an index and sold as fixed income paper to overcome the penal levels of taxation otherwise levied on hedge funds. Index certificates, however, are expensive to structure, and a number of tax and other issues surrounding them were only resolved in the 2004 Act.

GLG has also been selling an existing European long-short fund domiciled in the Cayman Islands. But

according to Benigni, a German-registered fund is a lot more marketable to investors like pension funds, Versorgungswerke (privately-run pension schemes for doctors, architects and other professional bodies) and, above all, insurance companies. The act allows insurance companies to invest an additional five per cent of their assets in hedge funds, taking the maximum to 10 per cent, creating an even bigger investment pool.

Launching a hedge fund can be a complex business for inexperienced market players. German-domiciled hedge funds can only be launched and sold by a German KAG, which acts in law as the regulated asset manager but can delegate the investment advisory and other functions. The KAG administers the fund. It liaises with the regulator, helps establish the strategy and define the risk parameters for value at risk, writes the prospectus, helps with capital introduction, provides monthly client reporting, issues annual tax certificates and gets the fund audited. It also monitors the positions to ensure the fund is being managed within the risk limits laid down. The legislation also requires that a German

Depotbank be appointed to provide all the necessary fiduciary services, including custody (though it can appoint a subcustodian, which is usually the prime broker). The Depotbank verifies and approves the net asset value calculations and monitors the fund for compliance with the rules of the fund. Few non-German asset managers are likely to go to the trouble of setting up their own KAG. According to Benigni, GLG chose Citigroup's Master KAG for two reasons. He says: 'When we looked at the market, most of the other KAGs were either set up to support only in-house funds, were not ready, or were geared to support funds of funds rather than single-strategy hedge funds. 'Citigroup's KAG was the only one with the capabilities we needed, but we would have gone with them anyway. They have the institutional strength and were very supportive in every single aspect of the setting up of the business.'

Citigroup is also the only provider offering a one-stop shop service - what amounts to a turnkey solution - which Uto Baader says was an important. 'We wanted to be able to deal with one company,' he says. 'Citigroup were very helpful in guiding us through the process. Their reputation and status was also important to us.'

GLG, like Baader and arsago, uses not only the Master KAG, but also Citigroup's Depotbank and its prime broker in London. The Master KAG is also set up to operate in tandem with third-party custodians and prime brokers, and hence offers a scalable solution. There is no conflict of interest as Citigroup does not have its own asset management business. Reputation matters in a German marketplace that remains wary. Says Sittmann: 'Not many foreign hedge fund managers are well known in this market. It helps if you can say that Citigroup has done the due diligence. We have a proven record in the funds market.'

'Investors are happier with a recognised name, one where there is less operating risk. Also, Citigroup has a competitive solution: as well as Germany, our fund administration systems are also used in Ireland and Luxembourg so we have economies of scale here and a proven track record.' The Master KAG structure itself offers benefits. First, it eliminates the high structuring fees paid by investors for index certificates or other bespoke programmes. Second, it delivers transparency of administration, control and reporting. Benigni says that demystifying the hedge fund business is key. 'When it comes to a black box, German investors shy away,' he says. To overcome this, the Master KAG at Citigroup produces monthly reports in the same format as long-only fund reports. 'Translating it all into German-style reporting is important,' Benigni says. 'Money will only come from well-informed investors who can read a detailed risk report. Transparency is important. German look-alike reports allow investors to ask the right questions and in turn, helps us find better, more stable investors. If we reduce redemptions, we reduce our own investor risk and get better returns.'

Benigni and Baader agree that the challenge this year and next is to increase the number of insurance companies investing in hedge funds. 'Many have had a mixed experience in funds of funds and are beginning to understand that funds of funds managers have their work cut out to deliver performance,' Benigni says. Ironically, the recent break in the bull market may have been a catalyst to prompt renewed interest in hedge funds. 'In nearly all markets, long-only funds were enjoying a good run, so people were not as eager as they might have been to invest in hedge funds,' Baader says. 'Perhaps new thinking will emerge following the fall in the market.'

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